

Table 5: Examples of Interventions

	TECHNICAL AREA	INDICATIVE DONOR INTERVENTIONS DRIVEN BY TRENDS
Globalization, consolidation and convergence	Crises Mitigation	<ul style="list-style-type: none"> • Development of contingency plans for crises management and mitigation (lender of last resort policy, capital market master planning, bank resolution master planning, etc.) • Mediation and design of cross-border cooperative arrangements for insolvency reform • Insolvency system reform • Develop innovative mechanisms for banks and regulators on the resolution and workout of troubled debt
	Capital Markets	<ul style="list-style-type: none"> • Targeted TA for the implementation of FSAP recommendations • Assistance in meeting EU integration requirements (CEE countries) • Support harmonization of regulatory standards and trading mechanisms - i.e. establish assistance packages that focus on standardized technology packages so that it would be reasonably easy at a later stage of development to move toward global or regional integration • TA for the deepening of financial markets. This may include new product innovations as described below, and/or more traditional product categories, such as government bond markets, that form the bedrock of a fixed income markets
	Regulation and Supervision	<ul style="list-style-type: none"> • Support for developing regulatory strategy, policy frameworks, and market-development oriented approaches for banks and non-banks • TA to improve the legal framework and supervisory capacity for consolidated regulation (with the entry into those markets by international financial conglomerates). • Support for the implementation of policies and guidelines on the proposed new Basle guidelines • Support for implementation of risk-based supervision and early warning systems • Support for the design and implementation of integrated supervisory structures that link bank and non-banks • Mediation and design of cross-border and domestic cooperative arrangements that broaden oversight and improve regulatory coordination • Development of intervention and resolution frameworks for distressed institutions • Assistance in developing mechanisms that catalyze interaction between regulators and the institutions they supervise • Support in the development of SROs; assistance in integrating SROs into formal regulatory operations • Legal reform, including strengthening administrative agencies, developing legal standards for judicial review of supervisory decisions, alternative dispute resolution

	TECHNICAL AREA	INDICATIVE DONOR INTERVENTIONS DRIVEN BY TRENDS
Information Disclosure and Governance	Banking and Non-Banking	<ul style="list-style-type: none"> • Support for the development and implementation risk management systems and procedures in response the proposed new Basle guidelines • Assistance in meeting EU integration requirements (CEE countries) • Support growth in non-bank subsidiaries such as leasing and insurance companies
	WTO Accession/Trade	<ul style="list-style-type: none"> • Build the institutional capacity to supervise and regulate a liberalized financial sector in line with international standards
	Accounting, Auditing, and Disclosure	<ul style="list-style-type: none"> • Continue efforts to adopt international accounting and auditing standards by: strengthening the accounting and auditing profession; development of national policies on auditor independence; development of sustainable SROs, assisting enterprises and institutions in converting their accounts to IAS, and harmonizing local accounting standards with global standards • Support for the development of laws and regulations for better disclosure; assist in the establishment of enforcement procedures and evaluative frameworks to ensure compliance with disclosure standards • Support development of credit bureaus
	Market Discipline	<ul style="list-style-type: none"> • Develop mechanisms that increase the role of market discipline in the operation of financial markets • Develop systems and tools that collect, aggregate, and disclose information on intermediaries, enterprises, financial products and markets (e.g. credit rating agencies, shared credit systems, etc.)
	Corporate Governance	<ul style="list-style-type: none"> • Assist countries to build legal framework and institutions to comply with the OECD principles of corporate governance • Increase measures for improved public sector governance, in particular of state-owned banks and asset management companies • Establishment of mechanisms to strengthen shareholder activism and communication of shareholder rights • Support in the design of governance structures for public institutions and agencies
Electronic Finance	Regulation and Supervision	<ul style="list-style-type: none"> • Assist in establishing new central policies on the regulation, extension of assurance, payment systems access of e-finance operations • Assist in evaluating the macro impact of new operations and exposure (e.g. on lender of last resort policies, commercial organization, and market structure) • Support revision of the legal framework for protection of consumers and investors • Support for the strategic evaluation of e-finance opportunities • Development of new institutions or mechanisms that leverage e-finance to increase access to financial services in under-served areas
Safety Net Reform	General	<ul style="list-style-type: none"> • Country assessments of safety net extension from the point of view of: suitability, design, efficiency, breadth of coverage, regulation and governance
	Pension reform	<ul style="list-style-type: none"> • Support for the overall development of pillar private pension schemes (policy, regulation, governance, financial management, advocacy and outreach, and capacity building) • Support for the reform and strengthening of state pension operations • Assist in the set-up, organization, function and design of a pension supervisory agency • Develop pension regulations (licensing criteria for pension fund management companies, advertising guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements) • Assist in upgrading technology for data collection and analysis to support the pension supervisory agency, pension funds and individual pensioners

	Technical Area	Indicative Donor Interventions Driven by Trends
	Deposit Protection	<ul style="list-style-type: none"> • Assessment of the suitability of depositor protection arrangements. • Support for the best practice design and development of deposit protection schemes • Assistance in the design and implementation of public consultation studies • Development of risk-based pricing approaches • TA for: improving the coordination between regulators and deposit insurance agencies; developing pricing mechanisms, reforming existing systems
	Investor Protection	<ul style="list-style-type: none"> • Assistance in the development and regulation of investor protection funds • Assistance in the strengthening of capital markets regulation for more precise protection of investors
New Financial Products	Derivatives and Securitization	<ul style="list-style-type: none"> • TA for the development and application of new product-market deepening technology; assistance in using this technology to facilitate financial intermediation where structural barriers that stand in the way of normal market development • TA on the public policies and regulation governing new technologies/products • Assistance in the development of risk management policies and procedures for new products • TA for the development of an enabling environment for special purpose vehicles, trusts, and other contractual vehicles - legal structures that facilitate risk-fencing of risk, the separation of ownership interest from beneficial interest, or secure capture of cash flow/collateral for pass thru securities • Market education, outreach and policy assistance on new technologies
	Credit Products	<ul style="list-style-type: none"> • Support for the development of credit products by: product design, training, infrastructure development, rating systems, etc • TA for the development of mortgage markets • TA for the development of corporate bond markets
	SME Finance	<ul style="list-style-type: none"> • Assistance to banks in developing strategies and service offerings under <i>SME banking</i>. (This goes beyond SME finance to include whole business strategies leveraging distribution channels, deposit products, and non-credit services) • Assistance to NBFIs and/or MFIs in providing SME-specific products

II.C. OPTIONS FOR OFFICE OF ECONOMIC GROWTH

II.C.1 OBJECTIVES

During the current USAID reorganization, the Office of Emerging Markets was dissolved and the Office of Economic Growth (EGAT/EG), a single office within the EGAT Bureau, will assume responsibility for providing field support and technical leadership in financial sector development. As implied earlier, we support the concentration of USAID/Washington's financial sector staff, rather than fragmenting them throughout the Agency, in order to allow them to accumulate the information and experience required to support the field. Yet, the reorganization has resulted in the overall reduction of Washington-based financial sector specialists. Accordingly, we would recommend that EGAT/EG ensure that it is staffed with a sufficient number of specialists to develop core technical competencies, in those areas identified in the section on key developments above²⁵.

The technical strengths of EGAT/EG's staff must also be consistent with the work to be done; that is EGAT/EG's technical leadership role must exist within a decentralized Agency. USAID continues to be a bottom-up operation with most of the decision-making and budgeting controlled in the Missions, with Washington offices providing support. Nonetheless, EGAT/EG has an important role to play through suggestion and recommendation of the strategic direction for the Agency's financial sector activities.

There are two main objectives of the Office of Economic Growth: field support to Missions for project selection, design, and project implementation; and technical leadership. These are described below.

- 1. Field Support:** At the country level, EGAT/EG should advocate that Missions use financial sector assessments, such as output from the joint IMF/World Bank Financial Sector Assessment Program (FSAP) or from a structured country classification exercise (topology), to select which technical assistance projects to support. EGAT/EG should assist Missions in project design, through its own resources, and by facilitating access to contractor and USG resources through its global mechanisms²⁶. EGAT/EG should be the driver of this process by ensuring that Missions have the information on current status of global markets and access to information on their domestic financial sector, including other donor activities. If there

²⁵ This final draft of this paper was presented in early December, 2002. By January, 2003, transfers from other bureaus into the EGAT Office of Economic Growth as part of the reorganization were completed and the number of staff dedicated to the financial sector specialists is expected to be five. We also understand that the 2003 budget is expected to be in the range of \$1.5 million.

²⁶ In recent years, the trend has been away from providing core funds as part of the IQCs. A similar mechanism for providing central funding for design should be considered.

were a significant event effecting the global or the partner country's financial sector, EGAT/EGAT/EG might take the responsibility to join with the Mission in conducting a new country strategy or revising the objectives of a financial sector activity.

Furthermore, EGAT/EG could take a more active role in ensuring that the projects chosen by the field Missions and Regional Bureaus are well implemented. Reaffirming this role will require continuation of existing global mechanisms²⁷; improving and maintaining an information database and website; requesting CDIE to undertake evaluations; better, more proactive interaction between EGAT/EGAT/EG, other offices, the Missions, and other USG agencies; and conducting conferences on lessons learned.

- 2. Technical leadership in new and existing programs:** The Office of Economic Growth should promote excellence in ongoing field programs and technical assistance areas that are new for USAID and that address key issues in financial sector development. The office should consolidate USAID/Washington's financial sector resources. These staff would undertake eminence activities that include research, knowledge management, and training. Implementation of this role might include issuing new umbrella contracts, drafting guidance for scopes of work for the field, undertaking targeted studies, and setting guidelines for what might be included in design of new financial sector development projects, among others.

Much of the infrastructure to meet these objectives is in place, but that does not cover all that is needed. EGAT/EG designed its cooperative agreements, contracts, and interagency agreements in ways that facilitate rapid access to professional technicians by Missions. EGAT/EG has staff well experienced in maintaining the contracts and agreements, ensuring continued availability of professionals to the Missions. They may use contractors under the SEGIR mechanisms and/or the US government and other specialists who can be accessed through the Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Financial Services Volunteer Corps agreements. During the past few years, EGAT/EG staff has been principally occupied with assuring compliance of these arrangements with the provisions imposed by the contracts. As a result, EGAT/EG staff has had minimal time to participate in designing and/or overseeing the implementation of individual scopes of work; understaffing has kept them from making the quality contributions they might have made.

During recent years, EGAT/EG has provided limited technical leadership for new initiatives. Resource cutbacks during the reorganization have left the Agency with less capacity among financial sector specialists in Washington. A

²⁷ This includes, most importantly, the maintenance and recompetition of the SEGIR contracts.



question now appears to be whether EGAT/EG can obtain staff that it will require to provide technical leadership. An objective going forward should be to provide EGAT/EG with additional financial sector specialized staff, some of whom may join with pre-defined responsibilities in the financial sub-sectors.

II.C.2 A CENTER FOR FINANCIAL SECTOR REFORM: POTENTIAL GLOBAL INITIATIVES

The most compelling reason for enlarging EGAT/EG's staff size is the accumulating body of evidence showing that there are greater opportunities than ever for bilateral donors to provide technical assistance in the financial sector. USAID leadership seems to have accepted the idea that greater financial sector efficiency leads to more rapid output growth and poverty reduction. Through the reorganization, EGAT/EGAT/EG has already become larger with more staff working on financial sector issues. It is also probable that, in line with the concentration of staff, the level of annual program funds will increase considerably. If a critical mass is reached (e.g., more than 5 financial sector staff including net new resources in Washington), then it might then be useful to establish an independent center for the financial sector work. This would create an identity for USAID's financial sector programs. A coherent financial sector policy for all USAID activities could be made. The financial sector center's professionals would become increasingly more available as a welcome source of leadership, information, and advice to the staff in Missions and other USAID/Washington offices than the workload currently within EGAT/EG will now permit.

Size will also determine the level of depth to which the Office of Economic Growth can fulfill its role to serve as a central point within USAID for information and access to resources on financial sector development during the next decade. In addition to leadership in new initiatives, EGAT/EG would have cross-country and cross-regional perspectives. Key issues that have emerged from the crises and technological changes that financial markets have undergone will continue to influence the sector's development for the next decade. EG's role in keeping abreast of these issues, dependent upon an increase of staff and program funds, can improve USAID's fundamental processes of project selection and implementation and ensure development impact of the financial sector reforms USAID Missions support. A thorough understanding of global and national level financial environments will assist the organization to guide Missions in defining the most effective types and levels of assistance.

Most importantly, EGAT/EG might consider initiating global programs which are consistent with its technical leadership mandate. EGAT/EG might work with Missions to implement pilot projects that address country-specific issues related to the key financial sector trends listed earlier. The criteria for global projects are those which would likely represent new approaches for USAID,

would likely require specialized expertise that might not be available within a given Mission, and could require some research and conceptual work to be performed in advance of a project to identify common problems across countries and develop tools to be used in solving them. EGAT/EG is particularly well placed to launch such pilot projects because it can take greater risks than Missions - assuming its mandate explicitly includes innovation and experimentation with new project designs.

In considering the list of global trends and the possible interventions, above, we suggest below some projects which meet these criteria and which EGAT/EG might undertake that would be meaningful to many USAID partner countries over the next decade. It should be noted that many of these are complex and perhaps better suited to more sophisticated financial markets. EGAT/EG may also consider interventions in building the basic foundation for a financial system in countries in which USAID is just initiating non-humanitarian assistance (e.g., Afghanistan):

- **Financial regulation and supervision.** EGAT/EG, by conducting evaluations, might undertake an analysis of USAID's banking supervision projects to date, identifying what has worked and what has not. Using this data and projecting the future needs for regulation and supervision, EGAT/EG could identify those areas which require additional assistance. Based upon this analysis of gaps, EGAT/EG could suggest to Missions the scope and content of second and third generation projects, such as consolidated regulation and supervision, surveillance and enforcement.
- **Compliance with international supervisory standards.** As described above, there is a need for extensive training and internships to upgrade supervisory capacity to meet international standards such as the Basle Core Principles or Basle II requirements, which can be done on a broad scale rather than by individual countries. EGAT/EG could employ implementers to design and deliver this training, sharing the costs of participation with Missions and with beneficiaries.
- **Rating agency/service development.** Under the new Basle capital adequacy framework, there is likely to be a significant increase in the demand for rating and risk management/ measurement services, providing an additional target of opportunity for USAID work. As this is a relatively untested area (although the E&E bureau has done at least one such project in Hungary), EGAT/EG might initiate a pilot effort in specific countries. There may even be scope for GDA involvement, teaming with Standard & Poors, Moody's, Fitch, or other US-based rating services interested in investing in developing countries.

- **Regionalization of securities markets.** We propose EGAT/EG undertake an initiative to determine how to harmonize or regionalize regulation, supervision, technology, and operations of capital markets. A technical assistance gap analysis or analysis of the pre-conditions for harmonization could then be used to guide Mission development of statements of work.
- **Prevention and enforcement of money laundering, terrorist financing, and financial crimes** are coming to the forefront and most Missions have not integrated these issues into financial sector programs. In parallel with the new World Bank initiative and those of the US Government, in collaboration with interagency partners, EGAT/EG could lead the Agency in tackling these issues.
- **Expanding markets through e-finance:** Again, this is an area in which EGAT/EG could take a technical leadership role in analyzing current research on e-finance, identifying potential interventions and then, assisting Missions to design programs through which they could assist financial institutions to introduce technologies that lower operating costs and that make it possible to provide financial services more widely.
- **Expanding access to finance for SMEs and for the poor:** USAID has funded several large SME finance activities, the impact of which is still unknown. It is now critical for EGAT/EG to evaluate and synthesize the successes and failures of these SME projects for future project design - which could incorporate measures to increase local capacity to provide technical assistance as well as financing to micro- and small businesses. Also, USAID's commitment to microfinance indicates a commitment to facilitate access to finance for the poor. Opportunities aside from microfinance to extend finance to the poor through conventional institutions merit further study.
- **New financial instruments development,** which results in better diversification of products and improved financial intermediation, is another innovative area for USAID. Some ongoing projects (India FIRE, Jordan AMIR, others in E&E) have included financial instrument development, but there is little yet understood about the success of these interventions in bringing new products to market. Not only might EGAT/EG commission evaluations to support future project design, but it might also continue training efforts (such as upcoming debt and mortgage market seminars funded by the E&E bureau) across regions.

II.C.3 FOUR SCENARIOS

In the pages that follow, we review EGAT/EG's options by analyzing increasing levels of staff and program resources. This analysis will help EGAT/EGAT/EG management to understand the technical difficulties in the pursuit of a financial sector reform "center of excellence" and the resources required. In our analysis, we treat those tasks which might at first appear to be administrative -- improving information flows, project evaluation, and liaison with other groups working in the financial area - as important as research and implementing new programs. The recommended tasks under each option will contribute substantially to fulfilling the Agency's work in the financial area and attaining EGAT/EG's objectives. Some tasks are presented in a base case, requiring no increase in the current level of resource, others would be expensive to implement and could not be undertaken by EGAT/EG without additional resources. The four scenarios are as follows:

- **Scenario A - Base Case Mission Support:** Two full-time equivalent (FTE) staff who are financial sector generalists and \$500,000 of annual program funds (assumes a small increase, if at all, from the current level of resources)
- **Scenario B - Better Mission Support through Evaluations and Assessments:** Two FTEs who are financial sector generalists and \$2,000,000 of annual program funds (assumes no additional staff, but a significant increase in program funds)
- **Scenario C - Improved Technical Leadership through Increased Technical Staff:** Four FTEs, including financial sector generalists subsector specialists, \$2,000,000 of annual program funds (assumes both additional staff and a significant increase in program funds from Scenario A)
- **Scenario D - Dedicated Center for Financial Sector Reform providing Mission Support and Technical Leadership through Global Programs:** Six FTEs, including generalists and sub sector specialists and \$5,000,000 of annual program funds (assumes a dedicated financial sector development department and sufficient funds to run multi-year, global projects). This scenario would allow for an increasing level of complexity with which financial sector development issues, listed in the section on global programs above, are addressed.

We keep our discussion of the Scenarios illustrative. We provide some recommendations for tasks in the Tables in Attachment 1. The next step is for EGAT/EG to define for itself what level of resource it may pursue and, accordingly, prepare a more definitive set of tasks. It should be noted that during the course of our work, we did not analyze EG's current activities at this level of detail. Consequently, the Scenarios are presented as a tool for EGAT/EG to use and adjust, rather than a set of well-defined work plans. Each task must in turn,

be analyzed according to level of difficulty in implementation. For the purposes of this report, we have classified tasks simply into the following categories: those with a high degree of difficulty to implement that will likely require agreement from and collaboration with organizations outside the Agency; those with medium difficulty requiring intra-agency collaboration among offices; and those with low difficulty tasks that could be accomplished with current and planned EG's resources. In the Tables, we offer a projection on the level of resources that might be required.

Scenario A: Base Case - Mission Support

Scenario A is the base case scenario. In this scenario, we assume there will be only two people assigned to a financial sector unit within EGAT/EG. This includes the SEGIR FS component manager and one additional person. We assume the amount of funds that the office programs will remain the same as in fiscal year 2002, \$500,000 per year.

Field Support

Of the Office's two objectives, with this level of resources, EGAT/EG will focus nearly exclusively on field support. In particular, they will support Missions by drafting, negotiating, and managing the three global mechanisms: the SEGIR global contracting vehicles, cooperative agreements (CAs), such as that with FSVC, and interagency agreements (IAAs). This is largely an administrative task, in which the SEGIR FS Component Manager will review scopes of work for technical merit, without adequate time for more comprehensive consultation. Based upon the team's findings, this is most valued work of EGAT/EG, and program resources should go toward improvement of this function. We found consensus among those interviewed -- USAID/Washington staff, contractors, and partner USG Agencies - that the SEGIR contracts are particularly effective mechanisms for delivery of technical assistance.

Currently, technical resources to assist Missions in project design are the SEGIR contractors, volunteers, or other US Agency personnel from, for example, the US Securities and Exchange Commission. EGAT/EG does not have the staff to provide much direct support to Missions in either project selection or project design.

Even with modest funds, however, under this scenario, EGAT/EG should use the majority of these program funds to undertake the research and planning needed to develop the methodology for country classification described above and to link the classification to appropriate design and sequencing of technical assistance projects. Most Missions should be able to determine into which of the proposed categories their country falls. Resources dedicated to implement the country classification process described above must be available from



Missions or the Regional Bureaus and ongoing validation and research must come from contractors. EGAT/EG will not have the personnel to dedicate to the topology, only to manage the contractor's efforts.

Knowledge Management

The remainder of EG's resources should be used to expand its knowledge management role. For example, as part of knowledge management, staff should update and maintain the database constructed as a part of this study, which lists USAID financial sector projects from 1988 to 2001. EGAT/EG may use program funds for this work and as well as for enhancement of their current website. EGAT/EG should continue its effort to collect and post statements of work in financial services, development experience documents, and progress reports. EGAT/EG should ensure those reports are submitted to CDIE repository. Furthermore, a dedicated knowledge manager might be hired.

Within the current level of resources, other improvements could be made. One area is in intra-agency communications. To date, EGAT/EG has used the results of this project for these purposes, through the team members' presentations. Going forward, EG's Office Director might schedule regular, unstructured luncheons with the heads of other USAID offices with large financial sector reform activities. EGAT/EG might arrange occasional retreats for all USAID/Washington and other US Agency staff working on financial sector reform. Such retreats (perhaps half-day to maximize participation) would give practitioners opportunities to make semi-formal presentations about their work and would give these diverse parties opportunities to learn who is doing what and how.

Scenario B: Better Mission Support through Assessments and Evaluations

Under this scenario, we assume that the EGAT/EG continues with only 2 people, but has a significant increase of program funds to \$2 million per year. In addition to the areas in Scenario A, above, the incremental increase of \$1.5 million in program funds will be used, for the most part, for financial sector assessments and for evaluations.

Assessments and Evaluation

With this level of resources, EGAT/EG will support the Agency by analyzing lessons learned in financial development and incorporating such practices into project design. USAID Missions could benefit from EGAT/EG core funding for conducting assessments - and by using the public documents produced as outputs from the FSAP/ROSC for project selection and design, made available by EGAT/EG²⁸. Moreover, EGAT/EG may take advantage of these in-depth

²⁸ OEM does not have the qualified personnel nor do USAID Missions have resources to undertake the level of diagnostic work done in an FSAP at a cost of \$600,000 per country.

studies to identify the key areas requiring technical support. In addition to the designing the topology (described in Scenario A), EGAT/EG could initiate a regular exercise to review the mission plans for financial sector TA against either the needs identified as a result of an FSAP or the topology.

As described above, USAID's most pressing need respecting financial sector reform, may be to find out what the results have been of past financial sector reform initiatives. EGAT/EG should continue its effort to collect and post relevant materials in financial services. However, with additional resources we propose that EGAT/EG design an evaluation program and begin to commission evaluations to be undertaken by CDIE and/or a contractor with the goal of developing material on lessons learned in those areas of USAID involvement.

Technical Leadership

A thorough understanding of global and national level financial environments will assist EGAT/EG to guide Missions in defining the most effective types and levels of assistance. It will also allow EGAT/EG to articulate a coherent policy regarding financial sector activities both within USAID and to its clients, partners, and implementers as well as to those outside the agency. EGAT/EG may do this in several ways:

1. Funding global programs, funding cross-border or regional activities
2. Providing knowledge management, through making statements of work, reports, contractor performance reports, as well as financial sector assessments and other relevant technical documents available on their website, and
3. Conducting research resulting in model statements of work, development of tools, and/or as advance preparation for pilot projects
4. Training staff through participation in international conferences and through modules for Mission staff in financial sector issues

However, with only 2 people, there will be insufficient EGAT/EG staff time to draft scopes of work or to manage actively new activities (i.e., serve as CTOs), other than the topology exercise. EGAT/EG will have to rely heavily on activities that are not as management intensive. Those probably include existing cooperative agreements only. If, on the other hand, core funding is used for SEGIR contractors, responsibility for management may have to be delegated to a CTO in another bureau or office.

EGAT/EG will have to balance its own resource constraints with the relative strengths of each group - contractors, cooperative agreement holders, and USG agencies -- taking into account the associated pros and cons. For example, reliance on USG agencies may result in a situation where only US financial markets approaches are considered, when a more global view might result in a

better project design. The business perspectives of market operations expertise or practicalities of implementation may also be missed. On the other hand, USAID might avoid the possibility that consultants may design a project that they are best suited to implement rather than one which addresses all the needs of the country, if only contractors are used.

In addition, another opportunity for EGAT/EG is to assume from the Regional Bureaus the responsibility for responding to Embassy or Mission requests specifically related to financial sector development. The result of decreased funding to the Europe and Eurasia region with the cut in SEED funding and the USAID reorganization is that fewer personnel resources available in E&E to manage regional activities. Using its global mechanisms (SEGIR, CAs, and IAAs), EGAT/EG might still fund central or regional activities with the objective of supplementing Mission funds. It may also fund regional activities, such as invitational travel for training seminars, workshops, or internships for development of skills among regulators and financial market participants and for which funds are no longer available.

Above, we list the potential areas for global programs. These should be developed further by EGAT/EG into an agenda for technical assistance or research. To repeat, the technical areas to consider are:

- Financial regulation and supervision
- Compliance with international supervisory standards
- Rating agency/service development
- Expanding access to financial services through e-finance
- SME finance and finance for the poor
- Regionalization of securities markets
- Prevention and enforcement of money-laundering, terrorist financing and financial crimes
- New financial instruments development

Training

There will be a need for more training of Mission staff in financial sector issues due to the limited headquarters financial sector staff. EGAT/EG has already asked a contractor to design training for Economic Growth staff, this should include additional modules on specific financial sector issues to complement the overall Economic Growth curriculum.

Scenario C: Improved Technical Leadership Through Increased Technical Staff

Under this scenario, we assume that EGAT/EG will increase its staff by two to a total of four people and the level of program funds will be \$2,000,000. Given current circumstances, it is likely that this will be the increase in staff as a result of the reorganization, although there are no net new financial sector specialists in Washington headquarters as a whole. It is envisioned that EGAT/EG will have more active involvement in financial sector assessments as EGAT/EG staff can go on temporary duty assignments (TDYs) to conduct or participate in assessments upon Mission requests. The EGAT/EG team will also be able to go further than they do currently in providing technical review and comment on Mission SOWs.

Assessments

With more staff, EGAT/EG could expand its role in financial sector assessments to include direct hire staff to conduct and participate in project selection activities. The ability to hire direct staff rather than use contract or other USG agency staff makes it possible to provide a unified USAID financial sector development perspective from the center to project design and contributes to continuity between and among countries. With direct hire staff, EGAT/EG should be able to review task orders and project activities proposed by Missions requesting support for projects and then compare them to the priority lists developed through the topology and assessment exercises conducted under A and B above. Additional tasks that could be undertaken with additional staff include the drafting scopes of work for USAID Missions, based in part, upon fieldwork and the evaluative work done by contractors or CDIE. Staff members could also design scopes of work for technical assistance in areas that individual Missions might not wish to fund entirely, but may wish to share costs with EGAT/EG.

Under this Scenario however, lack of specific expertise in financial sub-sectors, might still make it difficult for highly complex programs to be adequately assessed or designed. The need for highly specialized resources (e.g., electronic payments systems experts, actuaries) would be met by procurement from contractors, CA holders (volunteers), or USG agencies.

Global Initiatives

Although the program funds remain the same and our suggested list remains the same, with more people, EGAT/EG might spend the \$2 million per year differently. Most importantly, the significant difference between this scenario and Scenario B is that the range of global mechanisms which EGAT/EG might use is broader. This statement is based upon the understanding the contracting or use of IAAs is more labor intensive, requiring active CTOs.



The increase in staff will partially overcome constraint of CTO limitations to draft statements of work and actively negotiate and manage global projects. Accordingly, there will be scope for more active projects such as pilot programs in e-finance or regional capital market development. These might include regionalization or cross-border financial institutions or some of the new TA topics described above. Given the difficulty of negotiating IAAs, it would probably only be possible to, for example, agree upon an IAA with the Department of Justice for addressing financial crimes and Financial Action Task Force (FATF) compliance with more staff.

Scenario D: Dedicated Center for Financial Sector Reform Providing Mission Support and Technical Leadership

In Scenario D, two people are added in the EGAT/EG office for a total of six staff members, requiring new outside hires. We assume that the six are able to pursue sub-sector specialties in, among other topics, for example: banking, pensions and insurance, financial sector regulation, SME finance, accounting reform, and financial crimes. We also assume that these are incremental resources to the Agency as a whole, not just transfers from the Regional Bureaus. Each would manage his or her portfolio as, in this Scenario, the amount of program funds jumps to \$5,000,000.

While at first glance, this scenario may appear contrary to Administrator Natsios' vision of a Mission-driven organization and out of limits, there are a number of factors which have prompted its consideration in this review. Financial sector development is a global phenomenon. IFIs with levels of funding and influence similar to that of USAID (e.g., the regional development banks) already have dedicated financial sector offices. At this size, Financial Sector Development could become its own office, a "center of excellence in financial sector reform." In particular, the Center (a term we will use for this scenario) could assume a greater implementation role as well as undertake more extensive research. This may also allow USAID to take a more prominent role vis-à-vis other USG agencies or other donors by gaining additional resources and improving its internal programming significantly²⁹.

FIRST Initiative

Since Tasks 1 and 2 of this Financial Sector Review and Strategy project were completed in January 2002, the World Bank and IMF have announced the coordination mechanism, entitled the Financial Sector Reform and Strengthening (FIRST) Initiative. The FIRST Initiative is a multi-donor project, which states

²⁹ For example, we understand that, as part of multilateral negotiations on trade in financial services, the US Treasury is seeking to increase technical assistance as a lever to encourage market access. USAID should be part of this effort directly, through interagency coordination and through the IFIs.

its aim as developing robust and diverse financial sectors in developing countries. In particular, FIRST is supposed to provide the development response to the findings of the FSAP/ROSC process. To-date, \$45 million has been raised from bilateral donors to provide technical assistance grants to low and middle income countries for short and medium-term capacity building and policy development and will fund the provision of technical assistance to developing and transition countries in the areas of financial sector regulation, supervision and development.

Whether USAID chooses to join the FIRST initiative or not by contributing to the pool of funds, from the work in Tasks 1 through 4, we conclude that the FSAP/ROSC process is providing the best available financial sector assessment data currently available, due to the comprehensive nature of the reviews. At this level of resource, EGAT/EG could get directly involved in the FSAP/ROSC process -- through providing some grant funding and/or participating in the coordinating structure. This level of resource would allow EGAT/EG to at least have a dedicated person to collect information in a similar manner to that being done for FIRST, analyze it, and provide it to missions for their programming. This staff member could also be dedicated to the topology research and validation. With additional program funds, EGAT/EG will have the scope to provide grants or trust funds to international organizations to meet specific FS objectives, in particular around tallying and coordinating donor programs.

Financial Crisis Mitigation

As a result of the research and conferences conducted under Scenarios B and C, there might be scope for multi-year, multi-disciplinary regional implementation efforts. USAID could join other USG organizations and/or international organizations for activities related to financial crisis prevention, mitigation and resolution. EGAT/EG may even contract for a financial crisis rapid response team, to complement resources from the US Treasury. EGAT/EG may issue a new FS-focused research or project evaluation IQC.

Through the Center, USAID might develop the capacity to get involved in addressing financial sector crises. The Center could issue a contracting mechanism for crisis assistance, which would join IMF, World Bank, US Treasury, and regional development bank teams in crisis resolution. The Center might encourage financial crisis contingency planning in USAID-assisted countries, which is currently limited. In this, the Center would have the advantage of bringing to bear all its global mechanisms and therefore access to a wide range of governmental and private sector skills to the development of a solution.

Knowledge Management and Research

Lastly, under this scenario, we also propose that the Center broaden its research agenda. This scenario assumes that with more resources, there would more "thinking" time available in addition to the heavy administrative and contract management effort required under Scenarios A through C. This may allow EGAT/EG to expand its technical eminence and publish occasional papers on topics such as sequencing FS reforms or addressing the special circumstances of small financial systems. The research outputs that it could produce include: scholarly papers, regular evaluations and lessons learned articles, a regular newsletter, and seminars and workshops.

There could be occasional staff retreats on FS lessons learned or regular e-group discussions on FS topics. If done by direct hire staff, rather than contractors, there is greater likelihood of improving project selection and implementation, due to access to the Mission planning and procurement processes this allows.

USAID might also have additional program funds to provide to international organizations to encourage them to take on some additional responsibilities. These could range from introduction of new standards and codes by the IMF/World Bank, in, for example, housing finance or pensions, or collection and dissemination on what financial sector work is being undertaken by all the donors by an organization such as FSF.

II.C.4 CONCLUSION

USAID has implemented about 761 financial sector development activities since 1988. These were done absent of any Agency-wide financial sector strategy, yet on balance, probably met Agency goals. Looking ahead, a financial sector strategy will be critical to making improvements in project impact and sustainability. Even more importantly, USAID's mandate, resources, structure, and other key factors such as country conditions and other donors' activities are likely have greater influence on what projects are undertaken, than a formal strategy based upon specific types of financial sector technical assistance.

Moreover, how expansive EG's role will be going forward and what level of the activities it may undertake, depends on its resources. Scenario C, it would seem, would be consistent with the objectives of the USAID reorganization to improve support to the Missions. However, in considering Scenario D, management might also consider additional resources beyond having added staff and program funds in EG, while cutting technical expertise in the financial sector in the regional bureaus. With a net decrease in financial sector expertise, USAID may have limited its opportunity to solidify the accomplishments made to date.



The statement of work calls for a Forum to be held as a next step to this paper. Through the Forum, a relatively narrow USAID audience will contemplate the findings of the strategy work done to date and be allowed an opportunity to analyze and challenge the options. We propose that the topic for discussion at the Forum be:

- Key issues and trends in financial sector reform and what those means for USAID Missions as well as global programs
- Country topology
- Options for EGAT/EG

After the Forum, it will be up to EGAT/EGAT/EG management to make use of the recommendations in the paper and to move forward to secure the level of resources required to make a central financial sector unit viable and productive for USAID. They must consider several additional questions: What is the current donor, political and financial environment demanding of USAID - what are the internal and external pressures that might be forcing the organization to move in different directions? Will it do so on an ad hoc basis or will it go forward strategically - what is the field saying about the changes? In addition, to make those choices, management will have to think about the following factors:

- Expanded use of all three global mechanisms, SEGIR, the Cooperative Agreements and the IAAs and the effort within the office to draft, negotiate and manage those
- Possibilities for inter-agency cooperation, encouraged by the US stance vis-à-vis multilateral negotiations for increased trade in services
- Extent to which war on terrorism will continue to dominate US foreign policy

We look forward to discussing these questions with our colleagues in USAID and the development consulting community at the upcoming Forum³⁰.

³⁰ *Proceedings of the Forum held December 12-13, 2002 are provided in the Task 6 Report.*



The dramatic events of the late 1990s brought the issue of financial sector policy in developing countries to the forefront. Much of the international community's policy focuses on financial sector reform including strengthening the prudential regulations and supervision of the financial system along with ensuring that finance can make its most important contribution to economic prosperity through market-driven allocation of investable resources.

Caprio et al., 2002

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The authors wish to thank those who generously gave their time in relating their insight and experience in financial sector development during our interviews. In particular, we wish to acknowledge former colleagues from USAID, the International Monetary Fund, and the World Bank who made themselves and their work accessible to us. Above all, we thank our CTO, John Crihfield, for his painstaking reviews of our many drafts as well as Skip Kissinger, the SEGIR Manager, and Steve Hadley, the Director of the Office of Economic Growth for their guidance during this process.

EDITOR'S NOTE

On December 11 and 12, 2002, a USAID Financial Sector Review Forum was held. The contents of this report was distributed to many of the participants in advance and, on the 12th, three panels were held -- comprised of representatives from USAID implementers, other donor agencies, and from USAID. Each set of panelists commented on the contents of this paper. It has been revised to reflect some of those comments. Those who wished to submit written comments did so and those are included in Appendix 2.

Furthermore, it should also be noted that progress in the formation of a financial sector team in the Office of Economic Growth has been significant since this work began in September, 2001 and since delivery of the draft of this paper in early December, 2002. There are now five specialists assigned to EGAT/EG/EDFS who will work on the financial sector under the direction of the Chief, Enterprise Development and Financial Sector Division. Those individuals, along with peers from the regional bureaus, have formed a working group for the consideration and implementation of many of the recommendations provided herein.



Appendix 1: Table of Strategic Options For Role of EGAT's Office of Economic Growth

SCENARIO A: *Staff Resources:* 1 to 2 Dedicated FS Generalists
Budget: \$500,000 per year

OBJECTIVE	TOPIC	RECOMMENDED TASKS	IMPLEMENTATION	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	<ul style="list-style-type: none"> Develop topology (system for country financial sector classification) Ongoing validation and support of topology 	Medium	Dedicated CTO. Contractor cost: \$200,000 year 1, then \$50,000/yr.
Field Support: Project Implementation Guidance	Global Contracting Vehicles	<ul style="list-style-type: none"> Contract and administer SEGIRs: rebid as necessary Review and approve SOWs Collect SEGIR SOWs and post on SEGIR website Collect development experience documents, post on SEGIR website, and ensure they are submitted to CDIE repository Review quarterly or semi-annual progress reports Host annual review of SEGIR consortia (limited presentations) 	Low - Examples already exist, wealth of information on what works, OP and GC understand mechanisms	Component Manager to draft SEGIR FS RFP; negotiate and manage resulting contract.
	Cooperative Agreements	<ul style="list-style-type: none"> Administer CA with FSVC Develop and manage workplan for \$1 million grant to FSVC Review and approve Activity Action Plans 	Medium	FSVC: \$100,000Dedicated CTO
	Inter-Agency Agreements	<ul style="list-style-type: none"> Administer IAA with SEC, and, possibly, with FDIC and Treasury Review and approve work statements 	Low	IAA funding: \$100,000Dedicated CTO
Technical Leadership	Knowledge Management	<ul style="list-style-type: none"> Organize Economic Growth Sector Council and similar intra-Agency meetings and seminars 	Low	Generalist's time
	Research	<ul style="list-style-type: none"> Issue contract for study/validation of key FS development trends, e.g., in year 1 additional research on multilateral negotiations for increased market access in financial services, one study/year 	Medium	CTO\$100,000 per year
	Training	<ul style="list-style-type: none"> Attend relevant FS training/conferences held by World Bank and others Support FS course as part of Economic Growth Officers' training 	Medium -- possibly heavy time commitment	Access to information on training/ conferences offered; admin support to manage logistics



SCENARIO B: Staff Resources: 2 Dedicated FS Generalists
 Budget: \$2,000,000 per year (\$500,000 from A plus \$1,500,000 in new funding)

OBJECTIVE	TOPIC	RECOMMENDED TASKS	IMPLEMENTATION	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	<ul style="list-style-type: none"> Issue contract to design tool for use of FSAP/ROSC to support Mission programming as enhancement to topology 	Low to Medium	One time cost: \$50,000
	Project Evaluations	<ul style="list-style-type: none"> Conduct approx. two cross-country evaluations per year of SEGIR task orders by contractor and/or CDIE on topics such as: <ul style="list-style-type: none"> Lessons learned in USAID's SME finance projects, and design of sustainable SME financial institutions Lessons learned in Pension Reform, and implications for expansion of USAID's efforts (e.g., moving to Pillars 2 and 3) 	Medium	\$50,000 per evaluation; total \$100,000
Field Support: Project Implementation Guidance	Global Contracting Vehicles	<ul style="list-style-type: none"> Upgrade SEGIR Annual Review into Annual Lessons Learned Workshop (review of successful practices across projects) 	Medium	Cooperation of SEGIR Contract Holders
		<ul style="list-style-type: none"> Fund SMALL central/regional task orders under SEGIR FS IQC with the intention of assisting Missions in project assessments/design, 2 to 3 per year 	Medium	\$75,000 per task order; total \$225,000 per year
	Cooperative Agreements	<ul style="list-style-type: none"> Fund specific regional and/or global FS activities 	Medium	\$500,000 per year
		<ul style="list-style-type: none"> Fund annual work plans for central/regional activities 	Low to Medium	\$100,000 per year
Technical Leadership	Inter-Agency Agreements	<ul style="list-style-type: none"> Fund regional participant training and/or workshops which would not be funded by Missions 	Medium	\$5,000 per participant, total \$25,000 per year
	Knowledge Management	<ul style="list-style-type: none"> Enhance website (post SOWs, links to other IFIs); Contract for maintenance of database of USAID FS development experience Post/make interactive FS module for Economic Growth Officers 	Low	Webmaster/Contractor: \$100,000; ongoing cost might be \$2,000 - \$5,000 per month
	Research	<ul style="list-style-type: none"> Develop a research agenda Issue contract for studies of two timely FS development topics per year as per list 	Medium	\$200,000 per study; total \$400,000 support to manage



SCENARIO C: Staff Resources: 4 Dedicated FS Generalists
 Budget: \$2,000,000 per year (\$500,000 from A plus \$1,500,000 in new funding)

OBJECTIVE	TOPIC	RECOMMENDED TASKS (IN ADDITION TO SCENARIOS A AND B)	IMPLEMENTATION	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	• Send EGAT/EG staff to participate in assessments, 2 per year for 2 staff members	Medium to High	\$15,000 total
		• Support EGAT/EG staff TDYs to conduct/participate in financial sector assessments upon Mission request	Low	At Mission expense
		• Support design and implementation of Mission SOWs	Low	At Mission expense
	Project Evaluations	• Support EGAT/EG staff TDYs to conduct/participate in evaluations of FS projects, 2 per year	Low	\$10,000 total in travel expenses
	Donor Coordination	• Construct and maintain a web-based resource for Missions with links to international organizations' financial sector resources	Low	Part of website enhancement
Field Support: Project Implementation Guidance	Global Contracting Vehicles	• Implement TOs that individual Missions would not initiate, e.g., • Pilot programs in regionalization, • Cross-border financial institutions • Credit rating	Medium	\$100,000 to \$500,000 per task order Need CTO
		• Draft sample SOWs and tools for circulation to Missions, based upon "lessons learned" or from research	Low	\$75,000 per task order; total \$225,000 per year
		• Support EGAT/EG staff TDYs to assist in Mission SOW development	Low to Medium	Staff maybe should include sub-sector Specialists
		• Post annual reports on accomplishments for each TO on website	Medium	
	Cooperative Agreements	• Reallocate to Global Vehicles and IAAs		Replace \$600,000 to \$800,000 per year with task orders
	Inter-Agency Agreements	• Issue new IAAs with Dept. of Justice (for purposes of assisting countries with FATF compliance), or Dept. Of Labor (Pensions), or OCC & FED (bank supervision)	Medium to High	\$100,000 per year
Technical Leadership	Knowledge Management	• Hold occasional ½ day staff retreats on FS lessons learned	Low	
	Research	• Publish occasional research papers	Medium	
	Training	• Develop additional FS specific training modules as part of overall Economic Growth training for private sector officers	Medium	

APPENDIX 2: COMMENTS OF SEGIR-FS CONTRACTORS ON TASK 5 REPORT

CHEMONICS INTERNATIONAL COMMENTS ON THE FINANCIAL SECTOR REVIEW TASK 5 DRAFT REPORT

1. The importance of small and medium enterprise (SME) Finance

pg. vi. I don't agree that SME finance is not intrinsic to the stability or performance of the financial sector. According to World Bank statistics, 50% of US GDP and 60% of EU GDP comes from the small and medium enterprise sector. While the percentage is less in the developing countries in which we work, one can argue that it is the sector that has been most neglected by the formal financial system and that SMEs offer the greatest potential to create economic growth and generate employment in these countries.

While the FS IQC has been effective in improving regulatory frameworks, we must beware of over-regulation as it can hinder economic growth where it begins. In the future, when we have teams work on regulation and supervision, we need to have consultants from both sides of the equation - those that understand the needs of the traditional banking sector and those that understand micro and SME finance.

p.x I don't agree with the term "SME banking," as that implies that only banks can do SME lending, when in fact many NBFIs and MFIs have been very successful SME financiers. SME Finance is the better term and does include savings mobilization.

2. Globalization and e-finance

I love the focus on globalization and feel that is very important for the future of financial services. I also thought that the discussion on e-finance was great, but I would have liked to see more concrete examples of what you mean.

3. Role of Credit Bureaus

p.ix Under Information Disclosure and Governance, the role of credit bureaus should be included as a technical area. Credit bureaus are another way to supplement and strengthen the regulatory framework, and can be created relatively cost effectively by building off the information the central bank already collects from regulated financial institutions.

4. New Product Development

p. xiii The discussion on new product development is good, but we need to make sure new product development is market driven. We need to help financial institutions across the financial services spectrum to understand the diverse needs of their clients by segmenting the market and creating products that address the specific needs of each target market and segment. New product development should focus on the creation of savings vehicles as well as other non-loan products and services, i.e. leasing, etc.

5. Public Relations and Advocacy

I agree with the need for a greater emphasis on public relations and advocacy in projects to help sell our local partners and stakeholders on the project's vision. To do this, USAID missions need to allow for adequate time to build relationships and sell concepts before

pushing for immediate results. Many cultures are turned off by the American emphasis on productivity at the expense of relationship building.

6. Financial Sector Assessments

I think the idea of supporting the World Bank's and IMF's formal financial sector assessments is excellent. We need to think strategically how we will work to gain access to the information from the countries studied. Perhaps the best approach is to get involved in the pre-assessment preparation work, as then we will have already established relationships with the stakeholders and they will be more likely to share the information, which can feed into project design.

7. Need for Evaluations

We agree that there is need for more evaluations to ensure that the work done by contractors in USAID's name is effective. However, this need could partly addressed by making sure that proper monitoring and evaluation systems are set up at the start of a project. We have found that there is a fair amount of disagreement about how to measure success in financial services projects and as a result, indicators and targets can shift a lot over the life of a project. Perhaps we could work together to build consensus on what is most important to measure and how.

DAI COMMENTS ON THE FINANCIAL SECTOR REVIEW TASK 5 DRAFT REPORT

DAI commends Deloitte Touche Tohmatsu Emerging Markets, Ltd. for delivering an in-depth and well executed report for the Office of Economic Growth's Financial Sector Review and Strategy. The report's authors conducted a comprehensive financial sector review and proposed sound strategy, and we are pleased to have the opportunity to comment on the Task 5 Options Draft Report. We offer our observations in areas that we believe can be strengthened, most of which relate to item ten of the authors' Top Ten Suggestions for USAID/OEG:

"10. Strengthen the links between financial sector development and poverty alleviation" (p. vi)

We believe this suggestion is an important one, and that it requires elaboration beyond what is presented in the draft report. The report makes a clear case that a strong financial sector is a fundamental element of economic growth and poverty reduction, but unfortunately, avoids the subject of micro- and SME finance:

"...while micro- and SME finance are obviously important, they are not discussed here because donor projects in these fields are typically more concerned with extending the reach of financial services rather than improving the intrinsic stability or performance of the financial sector." (p. vi)

Page 10 of the report further states regarding microfinance:

"...these programs typically lie outside the financial core, utilize different intermediaries, and have staff not biased by crisis conditions."

Many of the world's most successful providers of micro- and SME finance are regulated financial institutions that form an important part of their country's financial core. Furthermore, regulated institutions that are part of the formal financial sector have proven most capable of expanding their outreach to massive numbers of poor people, microenterprises and SMEs.

Therefore we firmly believe that in order to strengthen the link between financial sector development and poverty alleviation, financial sector development initiatives should take into account the need to expand access to formal financial services. Along these lines, we offer comments in four sections below: Micro- and SME Finance as Part of the Financial Sector, Institution-building and Financial Sector Development, Expansion of Financing, and Regulation and Supervision.

MICRO- AND SME-FINANCE AS PART OF THE FINANCIAL SECTOR

Micro- and SME finance should be considered intrinsic to financial sector development. Inadequate access to financial services among microenterprises and SMEs constrains economic development and growth, as entire communities of entrepreneurs are

disenfranchised. Microfinance products are becoming an important part of formal financial sectors in the economies in which USAID works, as demonstrated by:

- Additional mobilization of savings from individuals who otherwise keep funds in their households. It is critical to financial sector growth as well as the overall economy to move these funds into the formal financial sector. The expanded liquidity also brings diversification of clients and products, reducing institutional risk and providing the base for consumer, institutional, and intra-bank product development.
- Creation of sector and institutional stability by providing saving and loan products, due to the vast size and funds flow in underbanked populations.
- Generation of economic growth from the expansion of small businesses, due to access to financial services (credit and deposit accounts at minimum). Institutions offering these services must be able to operate in a financial sector that supports them through proper laws and regulations: full participation as sanctioned financial intermediaries.

Increased outreach is an important goal of most microfinance projects, but to imply that USAID's recent microfinance interventions are independent of the financial sector runs contrary to the design and implementation of a number of important microfinance projects. Far from treating microfinance projects simply as outreach programs, the DAI approach to microfinance, developed in collaboration with USAID, is to ensure that financial services to the poor become an integral part of the overall financial sector, expanding outreach to the underserved while tapping their surprisingly large financial resources and meeting their financial needs.

We believe that in order to ensure that microenterprises and SMEs have ongoing access to services, it is necessary to promote:

- Sustainability/profitability of institutions and product lines targeting this market segment
- A facilitative legal and regulatory environment;
- Availability and use of high quality of information through credit bureaus and IT infrastructure, and;
- Improvement in the quality of support services (auditors, marketing specialists, training providers, etc.) that MFIs have at their disposal.

Financial services for the poor must be considered part of the financial sector if they are to be sustainable—through this approach the poor are explicitly included in the formal financial sector, offered services, and are treated as paying clients, as opposed to outreach project beneficiaries.

“people’s livelihoods – particularly those of the poor – largely depend on a strong financial sector” (p. 3)

Overall financial sector stability is fundamentally important: it is a necessary condition for large-scale poverty reduction. Nevertheless, it is not a sufficient condition for poverty reduction. The poor are likely to get indirect benefits from financial sector stability, but they also can benefit substantially from ongoing financial services. A client's comments from an impact assessment of the USAID-funded FOMIR Microfinance project in El Salvador, which has a relatively strong financial sector, helps illustrate this point:

With my loan, I purchased hair care supplies and more equipment. Prior to the loan I did all the work myself. Now with more equipment and an improved shop, I have enough customers to employ three people in my shop.

– Beauty Salon Owner in Ahuachapan, El Salvador¹

This testimony is representative of the sentiment among other clients interviewed for this and other microfinance impact assessments. If we are to speak of poverty reduction, we should not lose track of the people we are attempting to assist. We must understand that financial sector stability is important, but so is widespread access to financial services.

The general country classification system that the authors present suggests classification of countries based on vulnerability to crisis, commitment to reform, and size of the financial sector. We believe it important to include an aspect of access to services as an additional means of classification. Using the authors' definition of what constitutes a strong financial sector, it may be possible for a large financial sector in a reform-minded country to maintain a high level of performing assets and be relatively invulnerable to systemic shocks while also providing only a small fraction of the finance that microenterprises and SMEs require. We believe that a strong financial sector includes institutions, whether they are banks, finance companies, credit unions, or microfinance institutions, that are capable of serving microenterprises and SMEs, and that an element of access to financial services could also be used in a classification system.

As USAID moves into countries such as Angola, Paraguay, Laos, Cambodia, Afghanistan, and other states that have little financial sector infrastructure and capacity, the financial sector strategy must be sequenced properly and not focus on assistance that is beyond the country's ability. As nearly half of USAID's financial sector assistance has been directed to the transition economies of the former Soviet Union and newly industrialized states, the lessons learned may not be directly relevant to other contexts in which USAID will be operating.

To foster a dialogue on expansion of financial services to be programmed in next-generation SEGIRs, we present several financial sector options that should be considered in defining the Office of Economic Growth's financial sector strategy. The turn-around management and privatization of state-owned micro and agricultural financial institutions, the expansion of financing through provision of guarantees (through the Development Credit Authority) to financial institutions and small and medium sized

¹ Miller, Hillary and Galdamez, Ernesto. Client Impact Assessment. DAI's Rural Microfinance Strengthening (FOMIR) Project, USAID. El Salvador.

institutions, and effective regulation and supervision of institutions servicing micro, small, and medium sized enterprises will be discussed below.

FINANCIAL INSTITUTION-BUILDING IN FINANCIAL SECTOR DEVELOPMENT

In 1999, Ag Bank of Mongolia was in receivership after having been re-nationalized following a failed attempt at privatization. The government, however, was keenly aware of Ag Bank's importance to Mongolia's rural residents and the overall financial sector. Though Ag Bank was one of the smaller financial institutions in Mongolia by asset size, it offered nearly 275 points of service and was the only financial institution serving a large percentage of Mongolia's rural population. Ag Bank was the only bank able to transfer money, make payments (including pensions and salaries), and provide deposit services throughout Mongolia's vast territory. While business arguments suggested that the bank be closed, Ag Bank was a central player in Mongolia's financial sector.

The Government of Mongolia, with funding assistance from USAID, contracted DAI to manage the institution under a turnaround contract protected from political interference. As it was critical for the institution to remain open, the Bank developed products and services tailored to market needs. It found its best opportunity for expansion, stability, and growth through serving the Micro/SME sector.

New products were designed, piloted, and rolled out through a branch network. New Ag Bank lending products include microenterprise loans, SME loans, crop and herder credits, as well as pension advances and consumer lending. Ag Bank's branch network was found to be a strength, not a weakness. It provided unique access to Micro/Small markets with a high demand for financial services.

Ag Bank was able to provide products to a larger Micro/SME market while also increasing profitability to ensure institutional stability. This stability was crucial for the financial sector as a whole, as Ag Bank maintained its dominance as the main payment agency for the government. It now provides the largest number of loans in the country.

The lower income segment has often been ignored as banks tend to go after larger customers, often thought to hold the biggest profit opportunities. However, the Ag Bank created products to encourage the Micro/SME segment to save money, borrow and benefit from other products and services such as transfers. While the amounts may be small, with economies of scale, the Ag Bank discovered that it could serve this segment profitably and effectively.

The results from these new products and other restructuring initiatives have been impressive. Ag Bank has expanded its outreach to more than 350 locations. As of the end of November 2002, Ag Bank had disbursed over 370,000 loans, opened over 200,000 new current accounts, and increased savings deposits 400%. Bank assets have grown 500%. The level of loans in arrears has remained consistently less than 1% due to expansive yet prudent lending practices. The Bank began making a profit in January 2001, only six months into the turnaround, and the profits have grown monthly. The

current Return on Assets (ROA) and Return on Equity (ROE) exceed industry and country standards.

From a troubled beginning, Ag Bank is emerging as an example for similar institutions in other economies. By leveraging existing institutional strengths and creating products that meet market needs, the bank is profitably providing rural Mongolians with products that support growth in incomes and economic opportunities. The underserved market in Mongolia was the Micro/SME market and by focusing on this sector the institution flourished.

Financial sector development in Mongolia received an enormous boost from Ag Bank's privatization efforts. All bidders have been qualified and have performed their due diligence efforts, and the bank is on track to be privatized within the first half of 2003 at a multiple many times earnings. Investment has been attracted from outside, and Mongolia bank equity now has a market valuation standard. Without developing and implementing products for the Micro/SME sector, the institution would not have survived, let alone be attractive to financial sector investors.

EXPANSION OF FINANCING

When reviewing the types of projects proposed on pages 43 and 44 of the Financial Sector Review and Strategy (Task 5), those projects being designed under *Expanding Access to Finance for SMEs* and *New Financial Instruments Development* should consider incorporating leverage, using USAID's Development Credit Authority (DCA). DCA is a highly flexible mechanism used to leverage commercial funding sources and address market imperfections. DCA offers a 50 percent guarantee to lenders to partially underwrite the lender's venture into new types of lending: since DCA covers some of the lender's potential losses, the lender can learn how to lend to a new type of client or in a new industry with reduced risk.

SME Lending. The most common use to date of the DCA guarantee has been for a loan portfolio guarantee for banks interested in developing small- or medium-enterprise (SME) lending. A perceived limitation in lending to SMEs has been that to be safe, loans must be secured by collateral often unrelated to the business. By offering a loan portfolio guarantee, which authorizes the bank to decide which of its loans meeting basic criteria they would like to place under guarantee coverage, USAID has encouraged banks to try cash flow based lending, using the guarantee to substitute for heavy collateral requirements.

Microfinance. To enhance USAID microfinance activities, DCA loan portfolio guarantees have also been established with MFIs to encourage NGO microfinance institutions to expand their outreach and diversify their products and services. Additionally, a microfinance institution that needs funds for on-lending could source a DCA-guaranteed loan from a commercial bank or other intermediary financial institution.

Deposit Mobilization. If there is a limited amount of deposits in the commercial banking system, DCA might be used to guarantee bonds or certificates of deposit issued by the bank, to garner funds for on-lending. Since the bonds or certificates of deposit could have several month or even several year maturities, the guarantee would provide the institution with a source of funds for longer term loans. Longer term funding for banks and non-bank lenders will strengthen the overall financial system.

New Financial Instruments. In addition to encouraging lenders to innovate and test new credit and savings products and services, DCA can also be used to support the development of other financial instruments and markets, including: municipal finance; primary and secondary mortgage markets; pension funds; commercial paper and bond markets.

Partners for DCA and Relation to the Global Development Alliance. Partners for DCA guarantees can be any type of lender, including but not limited to: commercial banks; non-bank financial institutions such as credit unions or NGO microfinance lenders; leasing companies; supply creditors; and bond holders. While the lender is the party covered by the actual guarantee, partnerships have been formed through DCA deals with agricultural cooperatives, private housing developers, municipalities and community governments, utility providers, private guarantee organizations, and the local business community. All DCA deals are in essence Global Development Alliance projects if seen more broadly as a partnership facilitation mechanism, rather than simply as a financing tool.

REGULATION AND SUPERVISION

DAI is currently implementing two long-term microfinance projects that are funded through SEGIR-FS task orders (in Bolivia and in Ecuador). We are demonstrating to commercial banks that Micro/SME financial products and services can be profitable, and are assisting successful microfinance institutions and credit unions to professionalize their services and become regulated, sustainable institutions: fully participatory financial intermediaries, adding depth to the provision of formal sector services. DAI also works with regulators and ancillary service providers (such as credit bureaus, auditors, and local training providers) to build MFIs.

The case of Ecuador illustrates our industry approach to the development of financial services, and how microfinance fits into the formal financial sector. The financial crisis in Ecuador at the end of the 1990s led to the disappearance of nearly half of Ecuador's financial institutions. Many small-scale depositors found a safe haven in the country's largest credit unions, which has since led to rapid growth among the strongest credit unions over the past two years. All of Ecuador's strongest credit unions are now either regulated financial institutions, or in the process of becoming regulated. Credit unions form a fundamentally important part of the financial sector, especially for the poor, who are most susceptible to financial shocks. Credit union liquidity has provided ample cushion for temporary financial sector shocks experienced by traditional banks.

The SALTO project, a SEGIR-FS task order with USAID/Quito, works with credit unions, banks, and microfinance institutions that are either regulated entities, or that have made a commitment to become regulated. We have worked with the Superintendency of Banks and Insurance of Ecuador to develop the country's first risk-based framework for the supervision of microfinance and consumer credit products, and are developing practical supervision manuals. The regulations were developed based on international lessons learned, especially in Bolivia and elsewhere in Latin America on how to regulate microfinance and consumer credit, with the recognition that multiple types of institutions, including banks, serve a broad range of potential banking customers.

We are also working with the superintendency to build a legal framework that enables effective credit information-sharing to serve banks, credit unions, microfinance institutions, and non-financial service providers, while also respecting the privacy rights of clients. The goal of this initiative is to create an environment that is attractive to private investors interested in building a solid credit bureau that will benefit the entire financial sector, not just the microfinance providers.